LGIMA's Pension Solutions' Monitor

June 2020 Market Update

Overview

Pension funding ratios were broadly unchanged throughout the month of June, with the rise in global equities offsetting a grind tighter in credit spreads. We estimate that the average plan's funding ratio increased from 75.2% to 75.3% throughout the month.

Global equities

The equity market roared on, with the S&P 500 closing out its best quarter since 1998 (+20.5%). June saw a mix of COVID-19 shutdown restrictions wane and wax, resulting in 11 trading days closing with a change of greater than +/- 1.0% (eight of which were +1.0%).[1] Positive days were fueled by improved economic data, comfort from continued central bank stimulus and vaccine progress, while the few negative days were driven by fears of a "second wave" of the virus. Investors continue to struggle to reconcile equity market pricing to the seemingly slowing pace of positive turns in economic data.

Source: Bloomberg/Barclays and LGIMA as of 06/30/20.

US stocks (+2.0%) trailed international stocks (+3.4%) and emerging markets outperformed vs. developed as they began to close the wide year-to-date gap. Growth stocks continued their strong outperformance relative to value stocks, and small caps (+3.5%) outperformed large caps (+2.0%); that said, small caps still trail substantially year-to-date.[1] Volatility remains at high levels, with measures of cross asset class volatility still quite elevated, signaling that capital markets remain on collective alert.

In the US, the total return of S&P 500 sectors experienced mixed performance. Tech (+7.2%) led the way, followed by consumer discretionary (+4.7%), materials (+3.9%) and financials (+3.0%). The month was not positive across the board, however, as utilities (-1.3), health care (-1.3%) and energy (-1.0%) fell behind.[1]

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Interest rates

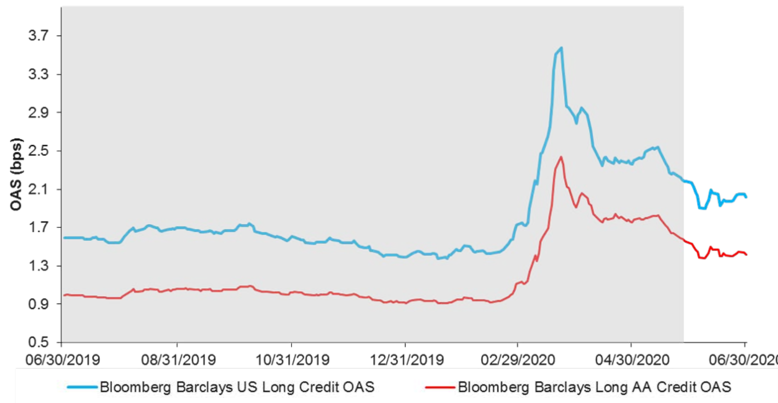
Source: Bloomberg/Barclays and LGIMA as of 06/30/20.

Rebounds in data and job numbers pushed long-end rates higher and the US yield curve steeper as the markets took on a reflationary tone for the first half of June. However, this reverted in the second half and essentially was unchanged on the month. The 30-year US Treasury rate closed out May at 1.41%. Within the first four trading days of June, this rate moved up to 1.63% on the back of a stronger than expected ISM (although still showing contraction as it was below 50) print, a rebound in ISM services, and the ECB announced they were expanding their Pandemic Emergency Purchase Program amidst other accommodations. The May employment report surprised even the most optimistic of economists. Nonfarm payrolls showed 2.5 million new jobs were created in May, compared to the consensus estimate of a 7.5 million job loss. The unemployment rate, previously at 14.7%, dropped to 13.3% (compared to a 19% estimate) as the labor participation rate moved up slightly. In the immediate wake of the data release, the 30-year Treasury rate spiked to 1.76% before rallying back later in the day to close out the first week of June at 1.67%. Some of this exuberance subsided the following week before the FOMC meeting on the back of equity weakness. Overall, the Fed meeting was slightly more dovish than expected. Although they projected rates to be on hold for the foreseeable future, their GDP forecast for 2020 seemed pessimistic with a -7.6% to -5.5% growth estimate. Rates plunged the day after the meeting as stocks fell nearly 6% and the 30-year Treasury rate closed at 1.40%. Rates grinded higher from there as consumer confidence showed an upswing. The long-end jumped up to 1.54% as the Fed announced that they would begin buying individual corporate bonds as part of the SMCCF and retail sales nearly bounced back completely with a 17.7% month-over-month growth.[1]

For the rest of the month, rates traded sideways on mixed data and a resurgence in coronavirus hot spots as states begin to reopen. New home sales jumped 16.6% higher, but the next day mortgage application data showed a -8.7% decrease. And despite the strong NFP numbers, continuing claims have remained fairly steady at 19.5 million (only a 1 million drop from a month ago), which is a concern as economists expected that number to fall more rapidly with re-openings. The reflationary story took a pause late in the month as crude oil dropped -5% in one session and steady buying in the long end, driven primarily out of Asia as the 20-year re-opening bull flattened the curve. The 30-year Treasury rate closed out June at 1.41%, the same level as in May.[1] At this point several states have put their re-opening timelines on pause as a potential second wave of infections is starting to become a real possibility and some hospitals outside NYC are starting to operate at near full capacity. With the Fed on hold indefinitely, it seems unlikely that rates can move significantly higher until infections are under control.

Credit

Throughout June, the investment grade credit market has rallied. As of July 1st, the US Credit index closed at 142 basis points, 22 tighter from the end of May. From a valuations perspective, the long-term median value since 2000 in non-recessionary periods is 123 basis points and in recessionary periods is 217 basis points.[1] At the current spread level, the market is no longer pricing in a recession, which is probably appropriate given activity has rebounded significantly; however, there is little compensation-cushion to absorb potential downside risks.



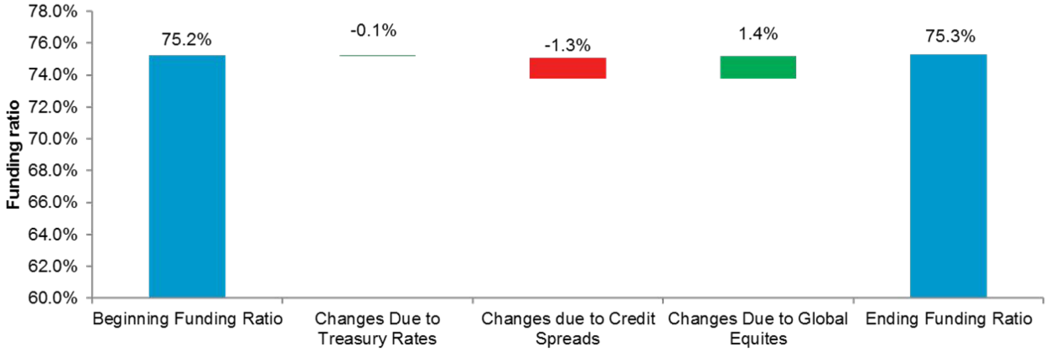
Source: Bloomberg/Barclays and LGIMA as of 06/30/20.

Initially post the downturn, macroeconomic data surprised to the downside, far surpassing what economists expected. Now that trend has reversed where data is surprisingly strong to the upside, as illustrated by Citi's US Economic Surprise index going from -144 at the end of April to +128 in June.[2] Government support and monetary stimulus has propelled the rebound as states have begun reopening the economy. Strong non-farm payrolls and US retail sales reports as well as high frequency indicators suggest growth is aligned with our economic scenario 1, closest to a V-shaped recovery. While the economic news has continued to surprise positively, the virus dynamics have deteriorated in the US. With activity at a higher than expected level, the risk of a sharper flattening off in growth has increased even if Congress delivers another round of fiscal stimulus. The extent to which the US can open up further is in doubt due to the increasing number of infections in several states in recent days. From a fiscal perspective, our economics team expects Congress to pass a stimulus in the $1-2 trillion range towards the end of July or early August.

So far, the narrative of a second wave from the virus doesn't seem to be affecting the market very much. Credit markets have benefitted from a favorable supply-demand technical. After companies rushed to raise liquidity in the immediate aftermath of the lockdowns, bond market issuance is returning to a more normal pace just as demand from Asia and central banks has increased. As seen countless times before, abundant central bank liquidity and a firm technical backdrop have also limited the price impact of growing geopolitical uncertainty. The outlook remains uncertain, particularly with an unpredictable global pandemic and upcoming US Presidential election on the horizon.

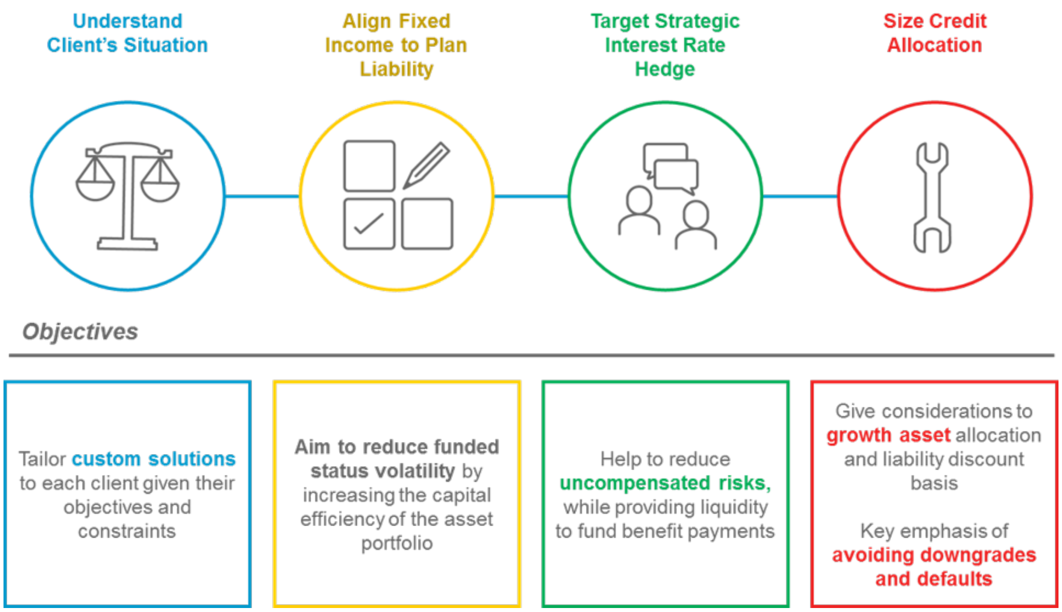
Funding status monitor

LGIMA estimates that pension funding ratios increased ~0.1% throughout June, with the impact due to rising equities offsetting the tightening in credit spreads. Our calculations indicate the discount rate's Treasury component was unchanged while the credit component tightened 12 basis points, resulting in a net decrease of 12 basis points.[3] Overall, liabilities for the average plan increased ~2.2%, while plan assets with a traditional "60/40" asset allocation also increased by ~2.2%.[4]



Source: Bloomberg/Barclays and LGIMA as of 06/30/20.

Principles of LGIMA's LDI philosophy



1. Bloomberg/Barclays
2. Citibank
3. Discount rates based on a blend of the Intercontinental Exchange U.S. Pension Plan AAA-A and Intercontinental Exchange Mature U.S. Pension Plan AAA-A discount curves.
4. For the average plan, LGIMA assumes a 60% allocation to MSCI AC World and a 40% allocation to Bloomberg Barclays Aggregate.